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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1950

No. 409

REYNALD H. CHASE,

Petitioner,

vs.

CARL J. AUSTRIAN AND ROBERT G. BUTCHER, TRUSTEES OF CENTRAL STATES ELECTRIC CORPORATION, A CORPORATION, DEBTOR, ET AL.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

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INDEX

	Page
Introduction	1
Opinions Below	1
Jurisdiction	2
Statutes Involved	2
Questions Presented	2
Statement of the Matter Involved	3
A. Structure of the Debtor	4
B. The Reorganization Proceedings of the Debtor (1942-1950)	5
Reasons for Granting the Writ	10
A. With Relation to Question No. 1	10
B. With Relation to Question No. 2	21
Conclusion	23
Appendix	24

CITATIONS

Cases:

Austrian v. *Williams*, 67 F. Supp. 223, reversed, 159 F. 2d 67, cert. granted, 330 U. S. 813, affirmed, sub nom. *Williams* v. *Austrian*, 331 U. S. 642; 80 F. Supp. 437	11
Central States Electric Corp. v. *Austrian*, 183 F. 2d 879	2
Committee v. *Kent*, 143 F. 2d 684	6
Consolidated Rock Co. v. *Du Bois*, 312 U. S. 510	18
Knight v. *Wertheim*, 158 F. 2d 838	18
Paramount Publix Corp., Matter of, 82 F. 2d 230	20
Reynolds Investing Co., Inc., Matter of, 6 S.E.C. 699	20
Universal Lubricating Systems, Matter of, 59 F. Supp. 171, affirmed, 150 F. 2d 832, cert. denied, 326 U. S. 744; 71 F. Supp. 775	20
Williams v. *Austrian*, 331 U. S. 642	11
Young v. *Higbee*, 324 U. S. 204	21

Statutes:

Page

Bankruptcy Act of 1898, c. 541, 30 Stat. 544; 52 Stat. 883:

Sec. 24 (11 U.S.C. Sec. 47) 2
Sec. 167 (11 U.S.C. Sec. 567) 11
Sec. 172 (11 U.S.C. Sec. 572) 9
Sec. 174 (11 U.S.C. Sec. 574) 19
Sec. 206 (11 U.S.C. Sec. 606) 21
Sec. 210 (11 U.S.C. Sec. 610) 22
Sec. 216 (11 U.S.C. Sec. 616) 18

Miscellaneous:

83 *Cong. Record,* Part 8, p. 9107 19
S.E.C., *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees,* Part 1 19
6 *Collier on Bankruptcy* 22

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Reynald H. Chase, petitioner, respectfully prays that a writ of certiorari issue to review the final decree of the United States Court of Appeals for the Fourth Circuit, entered in the above entitled cause on August 16, 1950 (R. 402).

Opinions Below

The memorandum opinion of the District Court of the United States for the Eastern District of Virginia (R. 282) is unreported. The opinion of the United States Court of

Appeals for the Fourth Circuit (R. 385) is reported in 183 F. 2d 879.

Jurisdiction

The final decree of the Court of Appeals for the Fourth Circuit was entered on August 16, 1950 (R. 402). The jurisdiction of this Court is invoked under Section 24(c) of the Bankruptcy Act [11 U. S. C. Section 47(c)] and under 28 U. S. C. Section 1254(1).

Statutes Involved

The pertinent provisions of Chapter X of the Bankruptcy Act are printed in the Appendix to this petition, *infra*.

Questions Presented

1. Whether a plan of reorganization of a *solvent* debtor under Chapter X of the Bankruptcy Act should be approved, as fair and equitable, which excludes common stockholders from participation in the reorganized company, when there is pending and about to be reached for actual trial, plenary litigation instituted by the trustees of the debtor against former management involving recoveries approximating $70,000,000, which or a portion of which, when added to the approximate $38,000,000 of non-contingent assets of the debtor would be sufficient to provide for participation by the common stockholders on a fully restored basis as the owners of the residual equity of the enterprise?

2. Whether the size of the holdings of securities of a debtor under Chapter X of the Bankruptcy Act by a party to the proceeding and the price paid therefor should be compared "with the magnitude of the interests * * * involved" (R. 388) in the determination of contentions advanced by the party in behalf of all of the security holders of his class?

3. Whether the absolute priority rule in proceedings under Chapter X of the Bankruptcy Act requires that the entitlement of the preferred stockholders of a *solvent* debtor be measured by the charter liquidation preferences of the preferred stocks, including dividend arrears in full, not discounted to present worth?

4. Whether a plan of reorganization is fair and equitable which provides for the payment of a bonus to senior preferred stockholders whose investiment position would be enhanced under the other provisions of the plan, and which bonus might, under particular circumstances, exclude from participation junior preferred stockholders who would otherwise participate?

5. Whether a plan of reorganization under Chapter X of the Bankruptcy Act is fair and equitable which provides for the valuation of the assets of the debtor, an investment company, on a liquidation basis of the market value of its underlying securities, rather than providing for valuation on a going-concern basis?

Statement of the Matter Involved

This case arises in the proceedings under Chapter X of the Bankruptcy Act (11 U. S. C. Sections 501, *et seq.*) for the reorganization of Central States Electric Corporation (hereinafter referred to as the "Debtor"), a closed-end investment company. The Debtor filed a voluntary petition in reorganization on February 23, 1942, which was approved by the District Court of the United States for the Eastern District of Virginia on February 27, 1942 (R. 409). Reynald H. Chase, petitioner herein, is the owner of eighteen hundred (1800) shares of the common stock of the Debtor (R. 409).

A. *Structure of the Debtor*

At the time of the filing of its petition in reorganization, the Debtor was, and it has continued to be, a closed-end investment company. It had two subsidiaries which were also closed-end investment companies. The first of them was American Cities Power and Light Corporation which has since been dissolved, allegedly in the course of the administration of the Debtor in the reorganization proceeding. The dissolution was effected on September 21, 1950. The other subsidiary was Blue Ridge Corporation which now constitutes the sole remaining subsidiary of the Debtor. American Cities and Blue Ridge were at all times solvent corporations, not under the jurisdiction of the reorganization court. However, at the time of the order of the District Court from which the appeal herein was taken, the Debtor owned directly 81.72% of the outstanding stock of American Cities; and directly and indirectly (through American Cities) 73.06% of the outstanding stock of Blue Ridge (R. 169, 414).

As of February 28, 1950, the capital structure of the Debtor consisted of: 5% Convertible Debentures, which had matured on January 1, 1948, in the principal amount of $6,300,000; and Optional 5½% Debentures, due in 1954, in the principal amount of $11,737,000. With accrued and unpaid interest added, the total claims of the debenture holders amounted to $20,672,268 (R. 297). The outstanding stock of the Debtor was made up of 68,800 shares of 7% Preferred Stock, having a liquidating preference of $6,880,000 and accumulated and unpaid dividends amounting to $8,869,467; and junior 6% preferred stock issues in three series, totalling 141,814 shares, having a liquidating preference of $15,599,540 and accumulated and unpaid

dividends of $15,670,448 (R. 297); and, finally, 10,105,023 shares of $1 par value common stock (R. 297).[1]

The solvency of the Debtor in both the equity and bankruptcy senses is unquestioned. The value of the Debtor's assets, at market value, as of February 28, 1950, ranged between $34,011,754 and $38,117,443 (R. 296). The total of creditors' claims against the Debtor was only $20,681,046 (R. 297).

B. *The Reorganization Proceedings of the Debtor (1942-1950)*

When the Debtor filed its voluntary petition in reorganization on February 23, 1942, the market value of its assets approximated only $1,400,000 (R. 193), against which it had creditors' claims amounting to $18,000,000 and large preferred stock dividend arrears (R. 193, 410). This situation had deteriorated from a high point in 1929 when the asset value of the Debtor was in the area of $350,000,000 (R. 185, 411).

On February 27, 1942, J. Cloyd Kent and Overton D. Dennis were appointed Trustees of the Debtor (R. 193, 410); and in September. 1943, they filed their Report pursuant to Section 167 of the Bankruptcy Act (11 U. S. C. Section 567), in which they disclosed probable liability to the Debtor in the aggregate principal amount of $4,132,000 on the part of Harrison Williams, who had been dominant in the affairs of the Debtor prior to the filing of the voluntary petition, and others associated with Williams, for fraud, misconduct,

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[1] By reason of their failure to file proofs of claim or interest, when required, approximately 5,000,000 shares of common stock held by Harrison Williams and his associates in the former management of the Debtor have been declared non-participating. There are, therefore, in effect, only the approximate 5,000,000 shares of the common stock held by the public which need be considered (R. 197).

mismanagement and irregularities. However, the Trustees recommended that no litigation be undertaken because recovery would be barred by the applicable statutes of limitations (R. 193, 410). The District Court confirmed the Trustees' Report over objection raised by the 7% Preferred Stockholders Committee (R. 410-411). An appeal was thereupon taken by that Committee to the Court of Appeals for the Fourth Circuit, which reversed the District Court in *Committee* v. *Kent*, 143 F. 2d 684 (1944). The appellate court directed that a more thorough investigation be instituted alluding to the fact that there was substantial evidence that additional claims would thereby be revealed against former management. The Court of Appeals observed also that with assests approximating only $11,000,000 in 1943, the only hope that the 7% First Preferred Stockholders had of receiving anything from their investment was for a recovery in lawsuits against former management, and that their rights in that regard ought not to be ignored (R. 411-412; 143 F. 2d, p. 687).

As a consequence, on November 15, 1944, Carl J. Austrian was appointed Trustee for the purpose of conducting the directed investigations; and with the resignations of Kent and Dennis, Robert G. Butcher was appointed Co-Trustee with Austrian on March 20, 1945 (R. 194, 412). Carl J. Austrian and Robert G. Butcher have ever since acted and are still acting as Co-Trustees of the Debtor.

The further investigations disclosed additional causes of action in favor of the Debtor, American Cities and Blue Ridge, against Harrison Williams and others associated with him in wrongdoing; and also inter-company claims by American Cities and Blue Ridge against the Debtor (R. 194-195, 412-414).

A plenary suit by the Trustees of the Debtor against Harrison Williams and his associates, entitled *Austrian*,

et al. v. *Williams, et al.,* was instituted on July 5, 1945, in the District Court of the United States for the Southern District of New York. A recovery of approximately $39,000,000, exclusive of interest, was and is sought. If interest be included, the amount in suit rises to over $70,000,000 (R. 414-415). The jurisdiction of the Court over the subject matter of the action was challenged by certain of the defendants, including Harrison Williams. The District Court found that it did not have jurisdiction and dismissed the action (67 F. Supp. 223), but the Court of Appeals for the Second Circuit reversed the order of dismissal (159 F. 2d 67). Upon the granting of a writ of certiorari (330 U. S. 813), this Court thereafter affirmed the order of the Court of Appeals (331 U. S. 642, 1947). Following the return of the cause to the District Court, the defendants moved to dismiss on the grounds of insufficiency and the bar of the New York Statute of Limitations. The motions were denied in all respects, but, however, without prejudice to the renewal thereof before the trial court (80 F. Supp. 437, 1948). The trial on the merits commenced on October 3, 1950, and at this writing is still continuing.

The inter-company claims against the Debtor were settled in January, 1948, for $500,000, $185,000 thereof being paid by the Debtor to American Cities and $315,000 to Blue Ridge (R. 195, 413). It had been the position of the Trustees that no plan of reorganization of the Debtor could be formulated until the disposition of the inter-company claims (R. 195).

In April, 1948, steps were initiated by the Trustees looking toward the ultimate formulation of a plan of reorganization of the Debtor. Several plans were proposed and the Trustees submitted a plan of their own.

In substance, the Trutsees' Plan (R. 260-281) provides that after the dissolution of American Cities, the Debtor

reorganize as an *open-end* investment company and thereafter merge with Blue Ridge (R. 266, 278-9).

The reorganized company is to have one class of stock, which will be distributed among the Debtor's debenture holders and 7% preferred stockholders in satisfaction of their claims and interests, allowing, however, for a premium or bonus to the debenture holders, and to the 7% preferred stockholders also if the 6% preferred stockholders should be accorded participation (R. 270, 281). The interests of the preferred stockholders are to be computed at the respective liquidation values of their stocks, including full accumulated dividends without discount (R. 269, 271, 280). Valuation of the Debtor's assets (other than the contingent assets consisting of the lawsuits against former management) is to be on a market value basis predicated upon the market of the five business days preceding the effective date of the plan (R. 263-4, 279). No value is to be placed upon the contingent assets, which are to be segregated and treated separately (R. 272, 281). The plenary suit against Harrison Williams and his codefendants is provided to be continued by the Trustees (R. 272, 281); *but the amount of the recovery therein is not provided to be added to the assets of the reorganized company.* Rather, the net amount realized in the plenary suit is to be distributed, in cash, in order of priority, in satisfaction of the theretofore unprovided for portions of the interests of the 7% and 6% preferred stockholders, following which the common stockholders are to receive the balance in cash (R. 273, 281). Accordingly, the common stockholders are afforded no participation in the reorganized company whatsoever, not even in the event of a recovery in the lawsuit. The same applies to the 6% preferred stockholders if the market values of the Debtor's assets on the five business days preceding the effective date of the plan happens not to be high enough to permit of their participation.

On August 25, 1949, Reynald H. Chase, the petitioner herein, a common stockholder of the Debtor, filed a Petition in the District Court for the Eastern District of Virginia (R. 409-419), seeking an order staying consideration of all plans of reorganization of the Debtor pending continued prosecution of the plenary suit against Harrison Williams and his co-defendants, upon the ground that in the circumstance of the Debtor, it would be unfair and inequitable to the common stockholders to proceed with the reorganization of the Debtor when the trial of the plenary suit was so close at hand.[2] Hearings on the Chase Petition, however, were deferred by the Court.

In the meanwhile, the Court proceeded to find the Trustees' Plan and four other plans submitted by interested parties to be worthy of consideration and referred all of them to the Securities and Exchange Commission for an advisory report in accordance with Section 172 of the Bankruptcy Act (11 U. S. C. Sec. 572). The advisory report was filed on December 20, 1949 (R. 181-250). It recommended approval of the Trustees' Plan only and suggested that it be modified in minor respects.

On February 1 and 2, 1950, hearings were held before the District Court on the Chase Petition and on the matter of the approval of the submitted plans.[3] At the hearings, all of the grounds upon which a writ of certiorari is herein

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[2] As already indicated, the trial of the plenary suit is in progress at the time of this writing.

[3] At that time, the Debtor and the Kelly Committee For 6% Preferred Stockholders submitted amendments to their plans previously filed. The amendments each provided for participation in a reorganized company by the common stockholders upon the contribution of fresh money. The amendments were predicated upon firm commitments by recognized banking institutions. Although these amendments granted participation to the common stockholders, which the Trustees' Plan failed to do, the District Court, nevertheless, held that the plans as amended were "not worthy of consideration for the purpose of submission to the Securities and Exchange Commission" (R. 255).

sought were strenuously urged by the representatives of the junior security holders.

On March 30, 1950, the District Court delivered its memorandum opinion approving the Trustees' Plan, subject to the amendments which had been suggested by the Securities and Exchange Commission. The District Court denied the relief sought in the Chase Petition and disapproved the plans of reorganization proposed by others than the Trustees (R. 282-288). An order in accord with the opinion was entered on April 24, 1950 (R. 252-260).

An appeal was taken to the Court of Appeals for the Fourth Circuit from this order by the petitioner herein, the Debtor and other representatives of the junior interests.

The Court of Appeals made its determination on August 16, 1950, affirming the order of the District Court (R. 385-401). Its final decree was entered on August 16, 1950 (R. 402).

Reasons for Granting the Writ

The scope of the discussion which follows is confined to Questions Nos. 1 and 2 of *Questions Presented, supra.* This is done in order to avoid duplication and repetition, inasmuch as other parties are also petitioning in this cause for a like writ of certiorari and will discuss in their petitions matters falling within the compass of Questions Nos. 3, 4 and 5 of this petition.

A. *With Relation to Question No. 1*

Question No. 1, *supra,* involves considerations of substantial importance to the effective administration of corporate reorganizations under Chapter X of the Bankruptcy Act.

The question strikes at one of the more important fundamentals of Chapter X and on the answer to it will depend

the degree of meaning to be accorded to an entire segment of the reform in corporate reorganizations that was avowedly accomplished by Chapter X. It is seemly that this question should arise in a proceeding that has already won a place of importance in the judicial history of Chapter X.

The concern here is with the concept of the independent trustee and his investigatory powers and duties under Section 167 of the Bankruptcy Act (11 U. S. C. Sec. 567), which is printed in the Appendix hereto. This Court, in *Williams* v. *Austrian*, 331 U. S. 642, 1947, had occasion to dissertate on this matter, in the very litigation (the plenary suit against Harrison Williams, *et al.*) about which Question No. 1 revolves. The cause now before this Court may properly be considered an aftermath of *Williams* v. *Austrian*.

Chief Justice Vinson wrote the opinion for the majority of this Court in *Williams* v. *Austrian* and, at pages 656-7 of 331 U. S., stated the following with respect to the conceptual innovation of the independent trustee and his investigatory functions:

> "To interpret the elimination of Section 23 in Chapter X cases as restricting the access of the trustee to the federal courts would not be in harmony with other provisions contemporaneously written into Chapter X and defining anew the position and functions of the reorganization trustee. The appointment of a disinterested trustee was made mandatory in appropriate cases, his qualifications were prescribed, and upon him were devolved functions aimed at eliminating the abuses of previous reorganization schemes. It was his duty to prepare the reorganization plan and *there were conferred upon him investigative powers and duties which not only contemplated the discovery of wrongs done the debtor by its former management, but also insured the 'prosecution of all causes of action' which might 'add to the assets of corporations in reorganizations.'*

> These provisions were 'of paramount importance in the revision of section 77B.' . . ." (Emphasis supplied.)

Petitioner's counsel have been unable to find any other matter in which the investigations of former management have proved so fruitful of litigation in behalf of the Debtor's estate. The magnitude of the claims against former management here is indeed of exceeding proportion. And not alone this; but we have also in this proceeding a history of successful struggle to bring about the investigations, a struggle which ended with a clarification of the meaning behind trustee investigations and rights with respect thereto. *Committee* v. *Kent, supra*, 143 F. 2d 684, was, it is submitted, a clarifying decision until the Debtor's reorganization revisited the Fourth Circuit Court of Appeals. It has now become an opinion that will breed confusion. Its holding was that, although the Debtor was then insolvent and the 7% preferred stockholders were deeply "underwater", the 7% Committee had enforceable rights to petition for further investigations of former management and that the opposition of debenture holders on the ground that this would necessitate delay in reorganization and the expenditure of funds that would otherwise go to creditors was not entitled to overriding weight. The language of the Circuit Court, at page 687 of 143 F. 2d, gave fulsome meaning to Section 167:

> "We think that the preferred stockholders had rights that ought not be ignored. They too had contributed capital to the corporation which was seeking reorganization, and their only hope of receiving anything from their investment was for a recovery to be had in behalf of the corporation from those who had mismanaged its affairs. 'All those interested in the estate are entitled to the court's protection.' *Case* v. *Los Angeles Lumber Co.*, 308 U.S. 106, 114, 60 S. Ct. 1, 6, 84 L. Ed. 110."

This language dovetailed with that of this Court in *Williams* v. *Austrian, supra,* made clear the reasons for trustee investigations of former management and the extent to which courts should go to make them meaningful to the interested parties.

However, the revisit to the Circuit Court has dispelled clarity. That Court apparently feels that while investigations should be ordered despite insolvency of the Debtor, and plenary litigation should be instituted, and funds of the estate should be expended in advancing the cases, nevertheless, the outcome of the suits need not be awaited and the avails of the litigation need not be returned to the estate. According to the Court of Appeals, reorganization may proceed through consummation even though the Debtor is fully solvent and the plenary litigation is at trial and its outcome may spell the difference between participation and non-participation in the reorganized company by junior security holders. It would appear that there is involved in this turn-about either an affront to common concepts of fairness and equity or the evolution of a new and highly indigestible concept which is at conflict with the principles advanced in the pronouncement of this Court in *Williams* v. *Austrian.*

It is appropriate at this point to consider the important difference to the common stockholders between securing a participating interest in the reorganized company and receiving, in dollars, the value of their interest in any recoveries in the pending lawsuits at a time subsequent to consummation of a plan of reorganization, which latter is what the Trustees' Plan provides. This consideration is coextensive with the benefit to the enterprise of the Debtor which would be secured by funneling back to the enterprise all of the recoveries in the lawsuits, as contemplated in *Williams* v. *Austrian.*

A participation by equity holders in the reorganized company allows for an uninterrupted continuity of interest in the affairs of the enterprise. Should the enterprise prosper, benefits flow to the participants. It cannot be denied, of course, that should the enterprise meet adverses the participants would suffer commensurately. However, the risk of advance or decline is one of the risks that investors in equity securities assume when they place their funds at the use of the enterprise. It is their expectation and hope that there will be an advance. That is why they invest in the particular enterprise. Theirs was the choice of investment and the choice was freely made.

It is not enough, in the case of the Debtor, to say glibly that inasmuch as there is a risk of loss as well as an opportunity for gain (R. 236), it is fair and equitable to presently exclude common stockholders from the enterprise and limit them, if recoveries are made in the lawsuits, to the receipt of dollars in the future, for their interests. The risk of loss was one they willingly assumed when they became common stockholders. The opportunity of gain, however, was the inducing factor for their investment. This opportunity they do not wish to lose; nor is it fair that they should.

It need scarcely be pointed out that if reorganization is accomplished now and dollars paid to the common stockholders in the future, the common stockholders may not be able to regain their position in the enterprise by purchasing their way back into it at the later date. Should the enterprise have prospered during the interim between consummation of the plan of reorganization and their receipt of cash, the dollars that the common stockholders would receive would necessarily buy for them a lesser interest in the going-concern than they would have had if the outcome of the lawsuits had been awaited.

It is not the fault of the public common stockholders of the Debtor that their interests in the Debtor are dependent

upon the lawsuits. The wrongs of former management were committed against them as well as against the debenture holders and the preferred stockholders, for it was the Debtor, as an entity, that was wronged. If former management had not committed these wrongs, there would now be no reorganization proceeding pending and the public common stockholders would be in a position of real interest in the enterprise. If the wrongs which were committed are to be fully righted, the enterprise should be made whole and all those who suffered as a result of those wrongs should be restored as much as possible to the positions they would have occupied had the wrongs not been committed. If this is not done, there is no real righting of the wrongs.

In the case of the Debtor, there is then an additional element at play which requires that, if possible, the public common stockholders be restored to their rightful position in the enterprise. This is the interest of the public which demands assurance from this Court that if wrongs have been perpetrated upon investors, the law will see to it that those investors will be restored to their investment and that they will lose nothing as a consequence, not even the opportunities that they believed were inherent in the enterprise. The reorganization of the Debtor is particularly a matter of vast public interest because of the tremendous impact upon public confidence in investment companies that was caused by the revelations of the reprehensible conduct of Harrison Williams and his associates. That confidence must be fully restored and this is likely only if it can be shown to the public that this enterprise did not ultimately suffer and that the position of all the investors in it was preserved.

The issue in the reorganization of the Debtor resolves itself into one of justice as among the several classes of stockholders of the Debtor. There need not and should not be an inequitable result as to any class simply because of

the comparatively short delay in prospect before the end of the litigation which is now in actual trial. There is no countervailing public or private interest which here calls for a sacrifice by the public common stockholders of an interest in the enterprise. It will severely penalize them to oust them from the enterprise simply because the courts, being subject to human limitations, cannot render instantaneous justice. Irrevocable decisions should not be made at a time when the essential information to make them according to equity is simply not available but is only a short time off. To delay for eight years to learn that enlightenment is within immediate sight and then to reorganize in the dark seems altogether indefensible.

The District Court in its opinion (R. 282-288) found it needful to explain away the apparent inconsistency in position that permitted it to suffer delays in reorganization for eight years while the estate increased in value from $1,400,000 to $38,000,000 and the 7% preferred stockholders emerged from under-water, and then, to refuse to countenance further delays when the 6% preferred and common stockholders pleaded for their opportunity. The District Court said (R. 286-7):

> "It is true that there has been a substantial increase in values resulting in greater benefits to certain security holders than they would have realize in a straight bankruptcy proceeding. *However, had an increase in value not been anticipated the corporation should have been liquidated long ago.* While there may be a further increase in value, upon the other hand, the market may go down. . . . If I knew what the future holds in this respect there would be no difficulty in reaching a decision. I do not know, nor does anyone else." [Emphasis supplied]

It appears anomolous that the District Court should admit, for the period from 1942 to 1950, to a perspicacity

concerning market movements that the ordinary investor certainly does not possess; and then, to profess a beclouding of the crystal ball just at that time.

It becomes apposite to examine into the "risks" to the positions of the creditors and 7% preferred stockholders that would be involved in a short further delay in the reorganization. Insofar as the debenture holders are concerned, there has been no agitation against them or their position by the junior security holders. If need be, no opposition would be raised to paying their claims in full, although it should in any event be recognized that their claims are covered by assets valued at market at almost 200% of the amount of the creditors' claims. Moreover, the carrying charges on the debenture issues, amounting to $960,535 annually can be and have been met in recent years. There is no reason why the debentures cannot be put on a current basis; and with that, their market value should be maintained at least at par so that any present holder of the bonds, as he chooses, may retain them as a continued investment or secure the full amount of his claim by selling his debentures on the market.

Moreover, as was alluded to in the opinion of the District Court (R. 287), the leverage in the system structure of the Debtor has been to a considerable extent eliminated, so that the probability of decline in value of the Debtor's assets, particularly of a recipitous nature, has been reduced to a minimum. (See also: R. 4-5). The elimination of leverage has been even further advanced by the dissolution of American cities, the intermediate subsidiary in the Debtor's system.

If the cry be (as it has been) that the securities market stands at the present time at a desirable high point and that reorganization should be immediately effected on that account, it is an argument that is ill made in a Chapter X

proceeding. It strikes at the vitals of *Consolidated Rock Co. v. Du Bois,* 312 U. S. 510, 1941, that reorganization on any particular day should be a matter of critical importance.

The Securities and Exchange Commission, in its advisory report (R. 181-249), contended that it is appropriate and fair to formulate a plan of reorganization in advance of the final disposition of the lawsuits primarily because of what it terms "a basic purpose of Chapter X to achieve the expeditious and efficient reorganization of corporations" (R. 235). The Court of Appeals apparently shared this view (R. 389). That Chapter X was intended to foster expeditious reorganization is not denied. However, to draw this single purpose apart from the many purposes that were intended to be served by Chapter X is highly improper. It is not fair argument to segregate this one purpose and thereby to attempt to so accentuate its importance that the other objects of Chapter X would appear to be entirely subordinate to this singled-out purpose. As Judge Learned Hand stated in *Knight v. Wertheim,* 158 F. 2d 838, 844 (CCA 2, 1946), "there can be considerations more imperative than the dispatch of judicial business, even after delays so long as existed in this case". Certainly, the evolution of a fair, equitable and feasible plan is one of the more imperative considerations.

Section 216(13) of the Bankruptcy Act [11 U. S. C. Sec. 616(13)], which is printed in the Appendix hereto, is advanced as the final argument against the Chase Petition (R. 235, 141).

Section 216 contains a specification of matters appropriately to be considered in the formulation of a plan of reorganization. It is, and properly should be, hornbook law that compliance with the provisions of Section 216 does not, in and of itself, render a plan of reorganization fair,

equitable and feasible so as to call for court approval. Indeed, the Bankruptcy Act itself is specific on this score. Section 174 (11 U. S. C. Sec. 574) provides, in part, that court approval of plans of reorganization must be predicated upon the opinion that the plans comply "with the provisions of section 216 of this Act, *and* * * * *are fair and equitable and feasible*".

In requiring that a plan must provide for the retention and enforcement by the trustee of claims not settled or adjusted in the plan, Section 216(13) is definitive in only one respect; that is, in its insistence that contingent claims be not disregarded. The Section does contemplate the *possibility* of the effectuation of a plan of reorganization despite the existence of contingent assets; but it does not tell us when this may be done.

It is submitted that the Debtor does not fall within those categories of cases in which reorganization has been or should be permitted despite the existence of contingent claims.

The legislative history of Section 216(13) indicates that while it had no counterpart in Section 77B, the *Paramount Publix Corporation* reorganization under Section 77B served as the model for the Section. (SEC, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees,* Part I, p. 310; and statement of Rep. Chandler, 83 *Cong. Rec.,* Part 8, 75th Cong., 3rd Sess., 1938, at p. 9107). In the *Paramount Publix* case, all security holders of the debtor were granted participation in the reorganized company and the common stockholders were fully restored to their position as the holders of the residual equity of the enterprise. Contingent claims against former management were provided in the plan of reorganization to be reserved by the trustee and prosecuted and should recoveries result,

they were required to be paid over to the reorganized company. In this connection, it was said that this "will benefit the corporation by strengthening its financial position and its security holders will be correspondingly helped". [*Matter of Paramount Publix Corp.*, 82 F. 2d 230, 233 (CCA 2, 1936).] The *Paramount Publix* reorganization represents the first category of cases in which Section 216(13) may today apply with propriety.

The second category is represented by the Chapter X reorganization of the *Reynolds Investing Co., Inc.* (See: *Matter of Reynolds Investing Co., Inc.*, 6 S.E.C. 699 (1940). The plan of reorganization there was of the liquidation variety. It followed, therefore, that such a plan could be consummated although contingent claims remained outstanding, because when recoveries should be made, they would simply be added to the cash realized in the disposition of other assets of the enterprise then being liquidated.

The third and final category is represented by the reorganization of *Universal Lublicating Systems, Inc.* under Chapter X. The Securities and Exchange Commission, in its advisory report (R. 236-7), and the Trustees (R. 141-2) rely upon this case as precedent for the proceeding in the case of the Debtor. It is submitted, however, that the situations of the two companies are poles apart. In the *Universal* case, there is graphically demonstrated the working of the economic factor which compels an emergence of the debtor from Chapter X immediately and despite the existence of other factors, such as the existence of undetermined contingent claims. [*Matter of Universal Lubricating Systems, Inc.*, 59 Supp. 171 (W.D., Pa., 1945), aff'd. 150 F. 2d 832 (CCA 3, 1945), cert. den. 326 U.S. 744 (1945); 71 F. Supp. 775 (W.D., Pa., 1947)].

In the *Universal* case, problems of working capital, extension of credit, procurement of materials and supplies, labor

relations, competition, needed rehabilitation of plant and equipment, and the assurance to customers and employees that operations will continue were all present and their resolution in a manner favorable to the enterprise depended entirely upon the immediate emergence of the debtor from reorganization and placing it in the charge of its creditors who were willing to advance needed moneys for working capital and other requirements. The only alternative to immediate reorganization was liquidation. In this circumstance, of course, reorganization proceeded despite the existence of undetermined contingent claims. But even then, the stockholders of the debtor were afforded an opportunity to participate in the reorganized company upon the contribution of fresh money.

That there is a sharp and fundamental difference between a commercial or industrial enterprise and the enterprise of the Debtor is recognized by the District Court itself in the instant case (R. 286). It is obvious that no problems such as were present in the *Universal* case are at work in the case of the Debtor. The *Universal* case is, therefore, no precedent here.

B. *With Relation to Question No. 2*

The reference in the opinion of the Court of Appeals (R. 388) to the size and dates of acquisition of the stockholdings of your petitioner and the price he paid for his stock is, it is submitted, improper and in direct conflict and disregard of a determination of this Court and the intendment of Section 206 of the Bankruptcy Act (11 U.S.C. Sec. 606).

It was the belief of your petitioner that his own stockholdings were a matter of no moment, since under principles enunciated in *Young* v. *Higbee Co.*, 324 U. S. 204, 1944, he would represent his entire class upon assuming an active

role in the reorganization; and, moreover, that it was one of the prime purposes of the reform movement which culminated in the enactment of Chapter X to give voice to inarticulate minorities in reorganization proceedings by allowing for full freedom of participation by any shareholder regardless of the size of his holdings, the dates on which they were acquired and the prices paid. [See: *Bankruptcy Act,* Sec. 206 (11 U. S. C. Sec. 606), and discussion at pages 2892 *et seq.* of 6 *Collier on Bankruptcy*].

Collier phrases it, at pages 2894 of his treatise (Vol. 6), as follows: "Section 206 thus represents an effort to encourage and promote individual participation in the reorganization by creditors and stockholders, and to foster 'democratization' of the proceedings". If this be so, then the Court of Appeals has attempted by judicial reaction to sabotage a Congressional reform, which, it is submitted, should not be countenanced by this Court. If permitted to stand, the opinion of the Court of Appeals in this respect will have struck a lethal blow to Section 206 and shaken the very foundation of Chapter X.

It should be stated, however, that the Court of Appeals in fact erred in describing the holdings of your petitioner as recently acquired and small in amount. As disclosed in the Statement filed by your petitioner's counsel pursuant to Section 210 of the Bankruptcy Act (11 U.S.C. Sec. 610), your petitioner's holdings date back to 1943 in principal part and to 1945 as to the balance; and it is there set forth that at the time that your petitioner assumed an active role in the reorganization proceeding, he was named as Chairman of a common stockholders' committee whose activities were voluntarily suspended, but not until it had procured authorizations from the holders of 233,348 shares of the common stock of the Debtor.

Conclusion

It is respectfully submitted that, for the foregoing reasons, this petition for a writ of certiorari to review the final decree of the United States Court of Appeals for the Fourth Circuit should be granted.

Dated: November 14, 1950.

Respectfully submitted,

GEORGE E. ALLEN,
Counsel for Petitioner.

NORMAN S. NEMSER,
STANLEY NEMSER,
LEO B. MITTELMAN,
Of Counsel.

APPENDIX

Pertinent statutory provisions of the Bankruptcy Act of 1898, As Amended, are as follows:

"Chapter X—Corporate Reorganizations

"Sec. 167 Powers and Duties; Trustee

The trustee upon his appointment and qualification—

(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;

(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;

(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;

(4) may, subject to the approval of the judge, employ such person or persons as the judge may deem necessary for the purpose of assisting the trustee in performing the duties imposed upon him under this chapter;

(5) shall, at the earliest date practicable, prepare and submit a brief statement of his investigation of the property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the judge may designate; and

(6) shall give notice to the creditors and stockholders that they may submit to him suggestion for the formulation of a plan, or proposals in the form of plans, within a time therein named.

"Sec. 172. Submission of Plans to Securities and Exchange Commission for Report

After the hearing, as provided in section 169 or section 170 of this Act, and before the approval of any plan as provided in section 174 of this Act, the judge may, if the scheduled indebtedness of the debtor does not exceed $3,000,000, and shall, if such indebtedness exceeds $3,000,000, submit to the Securities and Exchange Commission for examination and report the plan or plans which the judge regards as worthy of consideration. Such report shall be advisory only.

"*Sec. 174. Entry of Order and Fixing Time for Acceptance of Plan*

After the hearing, as provided in section 169 or section 170 of this Act, and if a plan has been submitted to the Securities and Exchange Commission, as provided in section 172 of this Act, then after the filing of the report or notice that it will not be filed, or after the expiration of the time for its filing, whichever first occurs, the judge shall enter an order approving the plan or plans which in his opinion comply with the provisions of section 216 of this Act, and which are fair and equitable, and feasible, and shall fix a time within which the creditors and stockholders affected thereby may accept the same.

"*Sec. 206. Persons Entitled to Hearings*

The debtor, the indenture trustees, and any creditor or stockholder of the debtor shall have the right to be heard on all matters arising in a proceeding under this chapter. The judge may, for cause shown, permit a labor union or employees' association, representative of employees of the debtor, to be heard on the economic soundness of the plan affecting the interests of the employees.

"*Sec. 210. Statement by Attorney*

An attorney for creditors or stockholders shall not be heard unless he has first filed with the court a statement setting forth the names and addresses of such creditors or stockholders, the nature and amounts of their claims or stock and the time of acquisition thereof, except as to claims or stock alleged to have been acquired more than one year prior to the filing of the petition.

"*Sec. 216. Provisions of Plan*

A plan of reorganization under this chapter—

* * * * * * *

(13) may include provisions for the settlement or adjustment of claims belonging to the debtor or to the estate; and shall provide, as to such claims not settled or adjusted in the plan, for their retention and enforcement by the trustee or, if the debtor has been continued in possession, by an examiner appointed for that purpose; * * *"

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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1950

No. 410

T. ROLAND BERNER,

Petitioner,

vs.

CARL J. AUSTRIAN AND ROBERT J. BUTCHER,
TRUSTEES OF CENTRAL STATES ELECTRIC CORPORATION,
DEBTOR, ET AL.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

T. ROLAND BERNER,
Common and 6% Preferred
Stockholder Pro Se,
30 Broad Street,
New York 4, N. Y.

INDEX

	Page
Opinions below	2
Jurisdiction	2
Statute Involved	2
Questions Presented	2
Statement	3
Reasons for Granting the Writ	6
Conclusion	26

CITATIONS

Cases:

American Coils Co., 74 F. Supp. 723	13
Anderson v. *Int'l Minerals & Chemical Corp.*, 295 N. Y. 343, 67 N. E. 2d 573	10
Case v. *Los Angeles Lumber Products Co.*, 308 U. S. 106	11, 18
Central States Electric Corp. (opinion below), 183 F. 2d 879	4, 8
Consolidated Rock Products Co. v. *DuBois*, 312 U. S. 510	18
Drewry-Hughes Co. v. *Throckmorton*, 120 Va. 859, 92 S. E. 818	9
In re Equitable Office Building Corp., unreported opinion of Mr. Justice Reed, August 6, 1946	27
Group of Investors v. *Chic. Milwaukee, St. Paul & Pac. R. R. Co.*, 318 U. S. 523	18
Hottenstein v. *York Ice Machinery Corp.*, 136 F. 2d 944 (C.A. 3)	10
Johnson v. *Johnson*, 138 Va. 487, 122 S. E. 100	9
Knight v. *Wertheim* 158 F. 2d 838 (C.A. 2)	20
Kyser v. *McAdam*, 117 F. (2d) 232 (C.A. 2)	25
Minn. v. *Ontario Paper Co.*, 7 S.E.C. 456	13
National Lock Co., 9 F. Supp. 432	24
Otis & Co. v. *S.E.C.*, 323 U. S. 624	6
Pennington v. *Commonwealth Hotel Construction Corp.*, 17 Del. Ch. 394, 155 Atl. 514	9
Portland Electric Power Co., 162 F. (2d) 618 (C.A. 9)	16

Page

Schwabacher v. *U. S.*, 334 U. S. 182 14
S.E.C. v. *Central Illinois Corp.*, 338 U. S. 96 14
Susquehanna Chemical Corp. v. *Producers Bank & Trust Co.*, 174 F. (2d) 783 (C.A. 3) 13
Vanston Bondholders' Protective Committee v. *Green*, 329 U. S. 156 25
Windhurst v. *Central Leather Co.*, 105 N. J. Eq. 621, 149 Atl. 36 10

Statutes:

Bankruptcy Act of 1938:

Sec. 24 2
Sec. 68A 13
Sec. 77 23
Sec. 107 24
Sec. 121 2
Sec. 171 ..... 3, 26
Sec. 174 ..... 2, 24
Sec. 179 24

Public Utility Holding Co. Act of 1935:

Sec. 11 23

Other Authorities:

Ballantine on Corporations 10
Dodd, in 57 Harv. L. Rev. 295 9
45 Harv. L. Rev. 1394 10
56 Yale L.J. 1420 12

SUPREME COURT OF THE UNITED STATES

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T. ROLAND BERNER,

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CARL J. AUSTRIAN AND ROBERT J. BUTCHER, TRUSTEES OF CENTRAL STATES ELECTRIC CORPORATION, DEBTOR, ET AL.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT.

The undersigned, petitioner herein, on behalf of 6% preferred and common stockholders of the Debtor, prays that a writ of certiorari be issued to review the decree of the United States Court of Appeals for the Fourth Circuit entered on August 16, 1950, affirming an order dated April 24, 1950, of the United States District Court for the Eastern District of Virginia. The order of the District Court approved the plan of reorganization submitted by the Trustees and disapproved the plans of reorganization submitted by the Debtor and by 6% preferred and common stockholders, pursuant to Chapter X of the Bankruptcy Act of 1938, as amended, 52 Stat. 883, et seq. (11 U.S.C., Sec. 501, et seq.), with respect to Central States Electric Corporation and its

two subsidiaries. The order also denied a motion made by a common stockholder to hold the various plans in abeyance until the determination of certain pending lawsuits against Harrison Williams and others, who were formerly in control of the Debtor.

Opinions Below

The opinion of the Court of Appeals (R. 385-401) is reported in 183 F. (2d) 879. The memorandum opinion of the District Court appears at R. 282-288. The advisory reports of the Securities and Exchange Commission are set forth at R. 181-250 and R. 250-252.

Jurisdiction

The jurisdiction of this Court is invoked under 28 U.S.C., Sec. 1254, made applicable by Sections 24 and 121 of the Bankruptcy Act of 1938 (11 U.S.C. Secs. 47, 521).

Statute Involved

Section 174 of Chapter X of the Bankruptcy Act (11 U.S.C., Sec. 574) provides in pertinent part as follows:

> "After the hearing . . . , the judge shall enter an order approving the plan or plans . . . which are fair and equitable, and feasible, and shall fix a time within which the creditors and stockholders affected thereby may accept the same."

Questions Presented

1. Where the corporate charter contemplates the immediate payment of all accumulated dividends out of assets only on final liquidation of an enterprise, and the enterprise, which is fully solvent, is in fact not being liquidated but rather rehabilitated under Chapter X of the Bankruptcy Act, does the rule of absolute priority require such immedi-

ate payment, even if it results in giving the preferred stockholders more than the economic worth of the contract rights they actually surrender?

2. Where a debtor is solvent and can pay its creditors in full with interest in cash, but these creditors prefer to take new securities instead in order to escape taxation and in order to obtain a bonus or premium, are such creditors entitled to such bonus or premiums?

3. Where a speculative, poorly secured preferred stock admittedly would sell in the market at a substantial discount, and its holders would prefer to exchange it for a common stock of unquestionably superior investment quality, are they entitled to a bonus or premium for "loss of position"?

4. May the common stockholders of a solvent corporation, whose rights are altered by a plan of reorganization, be denied the right to vote on such plan, especially where the common stockholders are accorded a participation thereunder?

5. May a plan be approved without giving to the stockholders the notice of hearing which is required by the plain terms of Section 171 of the Bankruptcy Act?

Statement

This case involves the plans of reorganization filed under Chapter X by the Trustees of the Debtor, and by the Debtor and 6% preferred and common stockholders, and also a common stockholder's motion to defer decision on the plans until the determination of a suit now on trial against Harrison Williams and others, who were formerly in control of the Debtor.

Central States Electric Corporation, the Debtor, is a solvent, registered investment company. It owns about 65%

of the common stock of Blue Ridge Corporation. American Cities Power & Light Corporation, an intermediate subsidiary, is now in process of liquidation. Blue Ridge, a registered investment company, is actively engaged in managing a general investment portfolio (183 F. (2d), at 881-2). The system owns a large block of stock of North American Co. which is in reorganization under Section 11 of the Public Utility Holding Company Act of 1935.

The Debtor is solvent at the present time in every sense of the word. It is able, without court assistance, to pay off its creditors in full. The Debtor's solvency has not been brought about by the operation or intervention of any plan of reorganization. It resulted solely from the increase in the value of assets owned by the Debtor at the time of the filing of the petition under Chapter X which the Trustees have not sold off. As of February 28, 1950, the claims of creditors were $20,681,046, whereas its assets were $38,117,443. Of the creditor claims, $11,737,000 mature in 1954 (R. 296-297).

The capital structure of the Debtor, apart from debt, is as follows as of February 28, 1950:

	Par Amount	Dividend Arrears
7% Preferred Stock	$ 6,880,000	$ 8,869,467
6% Preferred Stock	14,181,400	15,670,448
Common Stock (par value $1)	10,105,023	

(R. 297)

The claims against the former management of the Debtor aggregate, with interest, in excess of $100,000,000. The plenary suit of the trustees against Harrison Williams et al., which alone involves a possible recovery of over $70,000,000 is now actually on trial. The proceedings in that action have, to this point, favored the trustees. This Court has upheld the trustees as to the jurisdictional points involved and the District Court has already sustained the sufficiency

of the complaint and denied a motion to dismiss because of time limitations.

All the plans of reorganization which are now before the court provide for the rehabilitation of the enterprise and contemplate its continuance as a going concern rather than its liquidation.

The Trustees' Plan, approved below, provides for the liquidation of American Cities, which is now taking place, and for the consolidation of the debtor and Blue Ridge into a new corporation. This new corporation will be an open-end investment trust having a single class of stock which after an initial sixty-day period will be freely convertible into cash at "asset value". The new stock will be distributed to the holders of the debtor's debentures in amount equal to their full claim with interest, plus a bonus or premium of 5%; the stock will also be distributed to the holders of the 7% preferred stock until they have received an amount equal, at asset value, to $233.00 per share, plus a bonus or premium. No stock will probably go to the 6% preferred stockholders, in spite of the apparent equity for them, for this will all be consumed in reorganization expenses and the aforementioned bonuses. All stockholders will receive certificates of interest in the contingent assets —the aforesaid plenary suit.

The Debtor's Plan and the amended Kelly Plan both provided for retention of the three-company structure. The debentures were to be paid in full with interest, partly with the aid of bank loans, and the balance out of funds newly invested by the junior shareholders. The Debtor's Plan provided for exchange of the 7% Preferred stock for new stock, while the Kelly Plan left the class undisturbed with an improved position due to reduction of debt and interest charges.

The numerous issues necessarily raised by these plans

were discussed by the SEC in its advisory reports and by the District Court and the Court of Appeals in their opinions. But only five questions are submitted by the present petition. They relate to whether the Trustees' Plan approved below, is "fair and equitable" in (1) its failure to value the arrearages on the 7% preferred stock; (2) the bonus it gives to the debentures; (3) the bonus it gives to the 7% preferred stockholders; (4) whether it illegally excluded the common stockholders from a vote thereon; and (5) whether the stockholders received adequate notice of the hearing on approval of a plan.

Reasons for Granting the Writ

I. WHERE THE CORPORATE CHARTER CONTEMPLATES THE IMMEDIATE PAYMENT OF ALL ACCUMULATED DIVIDENDS OUT OF ASSETS ONLY ON FINAL LIQUIDATION OF AN ENTERPRISE, AND THE ENTERPRISE, WHICH IS FULLY SOLVENT, IS IN FACT NOT BEING LIQUIDATED BUT RATHER REHABILITATED UNDER CHAPTER X OF THE BANKRUPTCY ACT, DOES THE RULE OF ABSOLUTE PRIORITY REQUIRE SUCH IMMEDIATE PAYMENT, EVEN IF IT RESULTS IN GIVING THE PREFERRED STOCKHOLDERS MORE THAN THE ECONOMIC WORTH OF THE CONTRACT RIGHTS THEY ACTUALLY SURRENDER?

This case involves the question of the correct rule for valuing accumulated dividends on preferred stock in a business enterprise that is being rehabilitated as a going concern, and not wound up. It turns on the construction of a contract provision typically found in corporations with preferred stock having the right to cumulative dividends. Other corporations with charters including such provision are now in reorganization. The question is clearly of substantial importance in the administration of Chapter X of the Bankruptcy Act, cf. *Otis & Co.* v. *SEC*, 323 U. S. 624.

The precise question raised has never before been decided or seriously considered by this Court. It is believed, however, that the decision below is contrary to the clear inten-

tion of the parties in making their bargain and is in conflict with the elementary principles of fairness laid down by this Court in the *Otis* case *supra*. The decision below gives the 7% preferred stockholders more than the equitable equivalent of their preferential right to accumulated dividends, thereby giving them a windfall contrary to the policies of Chapter X.

If the decision is permitted to stand, it will not only work an injustice upon the 6% preferred and common stockholders in the instant case, but will also encourage preferred stockholders of corporations not now in reorganization to manipulate their corporations into a Chapter X proceeding for the purpose of procuring the same kind of windfall permitted below. The decision also misapplies the rule of absolute priority in such manner as to introduce great confusion into the administration of the Bankruptcy Law and other statutes where that rule is operative.

The Trustees' plan approved below gives to the 7% preferred stockholders, immediately, the face value of their accumulated dividends. *This result is reached, we submit, in plain defiance of the bargain the parties made,* thereby giving the 7% stock more than their due in a Chapter X proceeding.

A. *The Court of Appeals Misconstrued the Contract*

The contract between the stockholders entitles the holders of the 7% stock to cash to the amount of par value and accrued dividends in case of "liquidation, dissolution or winding up of the corporation, whether voluntary or involuntary", (hereinafter called the liquidation preference clause). Pursuant to the rule of absolute priority, which, we agree, applies, the senior stockholders get the full benefit of their contract rights, *but not more,* as against junior stockholders. (*Otis, supra.*) Accordingly, the 7% stockholders should now

receive the particular preference stated in the above-quoted clause of the contract *only if* the contingency spelled out therein has transpired; namely, if the reorganization provided by the approved Plan constitutes a "liquidation, dissolution, or winding up" within the meaning of the contract.

The Court of Appeals held expressly that there is no liquidation: "There is no basis for the contention that such a reorganization (i. e. the one in question) is a liquidation" (183 F. 2d, at 883). One would have thought that this would have disposed of the matter: if no liquidation, then obviously, no liquidation preference. But the Court proceeded to hold that while the Plan of Reorganization under review did not call for liquidation, it did call for a dissolution and winding up. Said the Court: "We think that, from the standpoint of these stockholders, the old corporation is being virtually dissolved and wound up and that a new corporation is being created as a result of the reorganization" (183 F. 2d, at 885). Evidently, the Court chose to see the form and ignore the substance. In *form*, Central is replaced by a Delaware corporation which then merges with Blue Ridge. But in *substance* the old business enterprise continues with substantially the same assets under the ownership of old security holders. The reorganization of the debtor under Chapter X, as a continuing enterprise, could be effected without terminating Central States as the corporate form. "The selection by the" Reorganization Court "of one method of system adjustment to accomplish" the debtor's rehabilitation "rather than another is an incident which ought not to affect rights." *Otis & Co.* v. *S. E. C.*, *supra*, at 631.

The Court below fell into error because it failed to analyze the contract for the purpose of determining the true intent of the parties expressed in the liquidation preference clause.

Dodd, in 57 Harv. L. Rev. 295, 309, has explained the origin and scope of this clause. At first, senior stockholders used to accept in the charter only the preference that dividends could not be paid to juniors until they received their dividends. But this did not protect them adequately where, as a result of financial or other difficulties, *the enterprise ceased business permanently.* Accordingly, sometime in the early 1900's it became customary to insert in corporate charters the clause now under consideration. The situation with which the clause was intended to deal indicates the scope of the clause. The clause was designed to give the stated, liquidating preference as against juniors only in the event the enterprise dissolved and wound up; only, that is, where there was involved "conversion of the assets into cash and distribution of the cash among creditors and shareholders" (Dodd, *supra*, at 309). "The underlying assumption (of the charter provision in question) was that the *enterprise* might become unsuccessful and *cease to function as a going concern* . . ." (*Ibid*, italics supplied.)

Thus, as Dodd's analysis shows, the preferred stockholders have two distinct preferences depending on whether or not the enterprise continues to operate. (1) While it is a going concern, dividends accrue which, under the going concern provision, must be paid before any earnings are distributed to the juniors; (2) When it ceases to function, destroying the opportunity for profits, and the assets are to be finally distributed, the liquidation preference clause applies to fix the amount of cash asset residue (after creditors are paid) to which each stockholder is then entitled.

This distinction is plainly brought out in *Drewry-Hughes Co.* v. *Throckmorton*, 120 Va. 859, 92 S. E. 818; *Johnson* v. *Johnson*, 138 Va. 487, 122 S. E. 100, and *Pennington* v. *Commonwealth Hotel Construction Corp.*, 17 Del. Ch. 394, 155

Atl. 514. For example, in the last cited case, the court characterized a charter provision substantially identical with the liquidation preference clause under review, as follows (Atl. at 517):

> "Paragraph E, however has no relation to the company as a *going concern;* it contemplates only the relation of stockholders inter sese after all creditors have been paid and *the remaining assets of the corporation are distributable to the stockholders.* (Italics supplied.)

Ballantine on Corporations, 688, interprets the provision the same way "as a matter of construction, this clause is intended to give a priority in the liquidation or distribution of assets". So a law review commentator explains the intent of the liquidation preference clause: "In all probability the contracting parties did not contemplate distribution of the corporate assets so long as that enterprise continued, whether or not the legal entity remained." (45 Harv. L. Rev. 1394, 1403).

In accordance with this intent of the parties, the courts hold that this clause does not apply upon a merger or consolidation. *Windhurst* v. *Central Leather Co.*, 105 N. J. Eq. 621, 149 Atl. 36, cited with approval in *Otis*, *supra*. *Hottenstein* v. *York Ice Machinery Corp.*, 136 F. 2d 944 (C. A. 3) (merger case, where the corporation with the preferred stock in question was not the surviving corporation); *Anderson* v. *International Minerals & Chemical Corp.*, 295 N. Y. 343, 67 N. E. 2d 573 (two corporations consolidated to form a third new corporation). In the *Windhurst* case, the court, "disregarding the form and examining the substance" (Atl. at 38), held there was no liquidation, dissolution, or winding up within the meaning of the liquidation preference clause, because the merger of the two corporations contemplated "the carrying on of the activities of each of them in a new form . . . it is not

provided that the board of either shall proceed to wind up its business and affairs. There is no provision for liquidation and distribution." (Atl. at 37).

That the liquidation preference clause envisions an actual cessation of the business enterprise is evident from its requirement *that the payment be in cash.* The clause provides simply that upon the reduction of the assets to cash and the resulting final distribution thereof, the senior stockholders shall get a stated portion of that cash. It is a perversion of intent to apply the clause, where assets are not being sold and cash dispersed, to the reallocation of securities in a going concern.

The Reorganization Plan approved below allows for the continued accrual of dividends on the 7% stock while the debtor remains in reorganization. This could not be justified except on the theory that the enterprise is a going concern. (*Pennington* and *Drewry-Hughes cases, supra.*) Yet certainly the form of enterprise was radically changed by the institution of the reorganization proceeding: control passed from the common stockholders to the court. (*Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 127.) If the contract rights of the parties are construed to hinge on the form of the enterprise, then the ouster of common control by the Reorganization Court must be deemed to have terminated the bargain for further accumulation of dividends (cf. *Pennington,* supra, 155 Atl. at 520-1). But if dividends continue to accrue despite this change, it must be because the charter rights were intended by the parties to depend on whether there was continued operation of the shared enterprise without regard to questions affecting the corporate entity.

Since the provision is not intended to apply where the business enterprise continues, it is not applicable in the instant case: The Court of Appeals expressly found that

the enterprise is not being liquidated and none of the respondents below urged otherwise. Indeed, the Trustees secured a closing agreement from the Bureau of Internal Revenue on their representation that the Plan of Reorganization did not contemplate a liquidation.

The Court of Appeals suggests that because the clause would have been operative in straight bankruptcy it must be applicable here (183 F. 2d, at 885). But this is a clear non-sequitur. In an ordinary bankruptcy, the business is in fact terminated and the assets distributed: There is no continuity of proprietorship. Hence the intended application of the provision.[1] The same result should follow, of course, if the enterprise is in fact liquidated in any other proceeding, including one under Chapter X. The form of the proceeding should be no more determinative of rights than the form of the enterprise. (See conclusion of Note in 56 Yale L. J. 1420). By the same token, regardless of the nature of the proceeding, the clause does not apply where there is continuity of enterprise by way of assets and proprietorship. To hold that it does so apply is to change the bargain the parties made.

The same fallacy is inherent in the argument that the clause applies because "reorganizations . . . are substitutes for liquidation" (183 F. 2d, at 888). The catch, of course, is in the ambiguous word "substitute". If the quoted phrase means that reorganization of a company under Chapter X as a continuing enterprise "takes the place of"—that is, makes unnecessary—a liquidation that might otherwise have eventuated, it is clearly correct. This indeed was one of the primary purposes of enacting Chap-

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[1] Straight bankruptcy would in fact have wiped out the 7% preferred stock completely. Only the pendency of the Chapter X proceeding permitted the Debtor's assets to appreciate to the point where they exceeded its debts.

ter X. E. g., *Susquehanna Chemical Corp.* v. *Producers Bank & Trust Co.*, 174 F. 2d 783, 786 (C. A. 3); *Re American Coils Co.*, 74 F. Supp. 723; *Minn.* v. *Ontario Paper Co.*, 7 S. E. C. 456, 531. But it does not at all follow from this that the liquidation preference applies. Rather the contrary! Since liquidation has been avoided, there is no occasion to apply a clause which was intended to govern liquidation.

On the other hand, if the quoted phrase means that reorganization "takes the place of"—that is, creates the same rights as—liquidation, it is plainly wrong. The functional difference between the two—rehabilitation as against destruction of the enterprise—naturally produces differences in rights. For example, *Susquehanna Chemical Corp., supra,* holding that because of this functional difference the right of set-off in Section 68A of the Bankruptcy Act does not apply under Chapter X where the corporation is being rehabilitated.

And in the instant case the intention of the parties requires that reorganization as a going concern be treated differently from a liquidation.

B. *The Court of Appeals Misconstrued the Otis Decision*

The Court below, having erroneously presumed that the liquidation preference clause was applicable by its terms, then proceeded to discuss whether Chapter X frustrated this supposed intention of the parties. We agree, of course, that Chapter X, like its predecessors and the general bankruptcy provisions, gives effect to contract rights, as to amounts and priorities. This is the meaning of the standard of absolute priority (*Otis, supra*). *But absolute priority does not give senior securities a liquidation preference where not provided by their bargain.* This was the precise holding of the *Otis* case (*supra,* at 634-5).

The Court's reasoning in the *Otis* case is of importance here. Both the petitioner and the respondent there agreed upon the intended meaning of the clause in bankruptcy reorganizations, a type of proceeding not there involved, so that this Court had no occasion to consider this question. Instead, it simply assumed for the purposes of discussion that the clause covered bankruptcy reorganizations. In *S. E. C.* v. *Central-Illinois Corp.*, 338 U. S. 96, the Court made the same assumption in paraphrasing the *Otis* opinion. A not dissimilar assumption was expressly made in *Schwabacher* v. *U. S.*, 334 U. S. 182, where this Court stated (at 190) it would assume without deciding that the liquidation preference clause would have been applied to a Michigan authorized merger, only to *hold*, nevertheless, that it was not to be construed as being applicable to a merger under federal law. The Court of Appeals in the instant case was misled by its failure to recognize that the statements in the *Otis* and *Central-Illinois* cases concerning reorganizations generally were in the nature of assumption *arguendo* for the purpose of distinguishing, and not deliberate holding.

We have, in the case at bar, the actual issue that was referred to but was not before the Court or seriously considered, in *Otis* and *Central-Illinois*. We submit that *the actual holdings in* Otis *and* Schwabacher *and the underlying reasoning set forth on those cases (and repeated in* Central-Illinois) support the construction advanced in this petition.

In the cited cases, this Court stressed three factors in reaching the result that the liquidation preference clause was not applicable: (1) the company was solvent; (2) the clause was drafted before the Federal statute, under which the recapitalization or reorganization took place, was enacted; and (3) in each case the statute in question "contemplates (the reorganization) as a step in continuing the enterprise" (*Schwabacher, supra,* at 200). *The re-*

spondents must admit that all three factors are present in the instant case.[2]

The S. E. C., however, continues to insist upon applying the clause in Chapter X recapitalizations of going concerns because it has declined to abandon the underlying position which this Court refused to adopt in the *Otis* case. There the S. E. C. argued that while the liquidation preference clause was intended by the parties to apply to all reorganizations (where the form of enterprise was changed), the Public Utility Holding Company Act was inconsistent with, and therefore superseded, the contract provision. The Court, however, said it did not reach that issue because as a matter of contract construction this clause did not apply to unanticipated, federal statutory reorganizations of solvent companies. In the instant case, the S. E. C. and the court below simply refused to accept this Court's reasoning that the liquidation preference clause was *not* intended by the parties to apply to all reorganizations involving a change in the form of the corporate entity.

The courts below and the S. E. C. evidently hold that the rights of preferred stockholders are accelerated by treating rehabilitation under Chapter X as though it were a liquidation, even though admittedly it is not in fact a liquidation. This resort to fiction in arrant disregard of the real facts is certainly not sanctioned by *Otis*. In the case at bar, the "right" to the liquidation preference could not, in accordance with the terms of the contract, "mature"—that is, arise, become operative—since the stockholders have not voluntarily brought about liquidation and the creditors have not compelled liquidation. Indeed, the creditors could not compel liquidation because the debtor is solvent (cf. *Central-*

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[2] In *Schwabacher*, it will be noted, the liquidation preference was held inapplicable to a *voluntary* merger under a federal statute, the policy of which called for continuation of the enterprise.

Illinois, supra, at 136, n. 31). And in no event would the preferred stock whose rights we are considering, have the right to compel liquidation. "The bargain between preferred and common shareholders, that the former shall be preferred in liquidation *but shall have no power to compel liquidation,* is a bargain which is well-understood by investors" (*Dodd, supra,* at 301. Italics supplied.) Thus we do not have in the instant case any of the factual situations that, in the view of this Court, were intended by the parties to "mature"—that is, give rise to or bring into operation—the liquidation preference clause.

The Court of Appeals, quoting from an opinion of the Ninth Circuit,[3] argues that because ordinarily creditor claims to principal and interest mature in reorganization, "the claims" of the preferred "must be regarded as matured" (183 F. 2d, at 885). This fails to take into account the distinction between creditors and preferred stockholders. As *Central-Illinois* suggests (*supra,* at 136, n. 31) it is just at this critical point, that the analogy between creditors and preferred stockholders fails. *Dodd* (*supra,* at 300) states the distinction plainly:

> "But preferred shares are not liabilities at all; they are ownership claims. The liquidation preferences which are attached to them are not only immatured but without any maturity date. The owners of the preferred shares do, indeed, have priority in assets over the holders of another class of ownership claims—the common shareholders—*but only if and when liquidation or dissolution occurs.*" [Italics supplied]

[3] *Portland Electric Power Co.,* 162 F. (2d 618 (C.A. 9). The question raised in this case seems to have been whether dividends continue to accrue while the debtor remains active during the reorganization proceeding, up to the date the Plan is confirmed; see text above. In the *Portland* case, as in the other reorganization cases involving arrearages, the courts, regardless of any language they may have used, in fact gave the preferred substitute securities reflecting the fair investment value and not the nominal value of the arrearages.

The basic confusion of the court below is interestingly demonstrated by the fact that the conclusion it reached does not follow from, is, indeed, incompatible with, the one and only policy rationale it purported to give for the conclusion. The court held (183 F. 2d at 888) that the 7% stock must be given an absolute priority to "the equitable equivalent of their liquidation preference". We agree. But what is the "equitable equivalent" of a right to preference on liquidation where there is no present or prospective liquidation and the valuation is of a going concern? Certainly not the face amount of the accrued dividends. *Schwalacher* case, *supra*, at 200, where this Court rejected the face amount of accumulated dividends as the basis in a going concern valuation and held that the equitable equivalent of the liquidation preference was what it added to the "current values" of the preferred stock.

Instead of giving the preferred shares their equitable equivalent, as it purported to do, the Court of Appeals has given them a windfall, in flagrant violation of elementary legal and equitable standards embodied in Chapter X and at the heart of the decisions in *Otis* and *Schwabacher*. The parties never contemplated that the 7% stock would get dividend arrearages from assets (as distinguished from earnings) while the assets continued to be employed in their enterprise. The liquidation preference clause was never intended to impose a penalty, certainly not the drastic penalty decreed by the courts below. In a reallocation of securities, the 7% stock have an absolute priority only to the equitable equivalent of their right; namely, the value of the stock on a yield basis with the current investment worth of the chance that sometime in the future there will be a liquidation of the enterprise, voluntary or involuntary, or a voluntary recapitalization.

Contrary to the opinion below (*Ibid*), our interpretation

of the clause does not "render somewhat illusory the charter provisions for a preference". This statement is predicated on the erroneous assumption (*Ibid*) that on this interpretation the clause could apply only in the event of insolvency, when only creditors participate. But insolvency (in the bankruptcy sense) is obviously not the only contingency that may result in liquidation and winding up.

The precise issue raised here has never been considered or decided by this Court. It is of vital importance in the administration of Chapter X that this critical question be squarely considered and authoritatively decided. We submit that a correct construction of the contract, well-recognized principles of reorganization law and the standards of fairness and avoidance of windfalls in reorganization laid down by this Court in *Otis, Schwabacher* and *Central-Illinois, supra,* require review and reversal of the decision below.

II. IS THE BONUS OR PREMIUM TO THE DEBENTURE HOLDERS AND 7% STOCKHOLDERS FAIR AND EQUITABLE?

The Plan approved below, in its provision for a bonus or premium, gives the debenture holders and 7% stockholders more than full compensation for the rights actually surrendered, in contravention of the decisions of this Court. *Case v. Los Angeles Products Co.,* 308 U. S. 106; *Consolidated Rock Products Co.* v. *DuBois,* 312 U. S. 510; *Group of Investors* v. *Chicago, Milwaukee, St. Paul & Pac. R. R. Co.,* 318 U. S. 523.

Because there are material differences in this connection between the two classes of securities, which the Court of Appeals failed to note, we shall discuss separately the premium given to the bondholders and that granted the preferred stockholders.

A. *The Bond Premium Is Unwarranted, Since The Estate Can And Should Pay The Debt Off In Cash*

The Court of Appeals stated that the bondholders must be compensated because under the approved Plan "they cannot convert into cash for a period of sixty days" (183 F. 2d, at 888). The Trustees' Plan makes two assumptions here: (1) the bondholders want cash; and (2) the estate cannot pay them in cash. The courts below have failed to exercise the "informed judgment" demanded by this Court, by accepting these assumptions blindly and without examination. *Neither assumption is true in fact.*

1. The debenture holders have opposed payment of their claims in cash and have preferred the plan now under review which gives them instead stock in an open-end investment company. The reasons for this curious behavior are not far to seek. One, of course, is the bonus or premium of 5%—more than a million dollars—with which this plan rewards them.

The second reason is to be found in the extraordinarily favorable tax treatment which they will receive. If they were to be paid in cash they would not only have to pay heavy capital gains taxes where, as in most cases, the bonds were purchased at a fraction of their face value, but all of the interest arrears paid at once would be subject to full income tax liability in a single year. Under the plan so skillfully devised by the Trustees the debenture holders will realize no taxable income on consummation of the plan and will be able to postpone indefinitely any tax on capital gains.

2. Moreover, the estate can pay all its creditors in cash. The market value of the debtor's assets, whether taken now

or at the time the plan was approved, is greatly in excess of the claims of creditors with interest. As its balance sheet shows, the debtor had cash and readily marketable securities of more than $38,000,000. The claims of the debenture holders including interest amounted to less than $21,000,000. There were no other substantial claims.

The cash and Government Bonds held by the debtor and its subsidiary with which it is to be merged, amount to more than half of the claims. Substantially all of the remaining holdings are in securities listed on the N. Y. Stock Exchange or the N. Y. Curb Exchange. Under these circumstances there can be and is no question of the debtor's ability to pay off all of its debts in cash with or without refinancing.

The right of a solvent debtor to pay off its debts is beyond question. In fact the creditors have no standing in court to oppose such payment. (*Knight* v. *Wertheim*, 158 F. 2d 838 (C. A. 2)). Yet this elementary principle is here ignored.

Much ingenuity was spent in circumventing it. The first difficulty that confronted the draftsmen of the plan was "How can we justify a premium or bonus in view of the fact that the stock of an open-end company cannot sell for less than its full asset value? This problem was solved with a minimum of discomfort by making the stock non-redeemable for a sixty day period. This, however, raised the question of how such a provision could be justified. The best that could be done with that was to state that if the stock were made immediately redeemable, too many holders might rush in to redeem it. Just what the advantage was in having everyone rush in at the end of sixty days rather than immediately, is not explained. The necessity of time to realize on the sale of liquid assets cannot be the answer in view of the large holdings of cash and Government Bonds above

referred to, and the readily marketable nature of the rest of the portfolio.[4]

The gross injustice that will result if this Court permits this scheme to go into effect is readily apparent. The bonus to bondholders may easily make the difference between no participation whatsoever for the 6% preferred stockholders and a participation of some $8 a share. A bonus which substantially wipes out an entire class of securities is without precedent.

B. *The 7% Preferred Premium Is Unwarranted, Since Under the Plan They Do Not Suffer Any "Loss of Position"*

This Court has warned against the use of a "rigid formula" (*Rock Products, supra,* at 529) or "any mathematical formula" (*Group of Investors, supra,* at 565-6); but the courts below, misled by the S. E. C., have sanctioned just such a mechanical approach with regard to the 7% preferred bonus. The Commission evidently believes that the exchange of a nominally "senior" stock for a common stock automatically necessitates the payment of a "compensatory" bonus, regardless of the investment quality of the securities involved or other pertinent circumstances. The result is an unconscionable windfall to the 7% stockholders which, if uncorrected by the Supreme Court, will set a vicious precedent in other reorganization cases.

The Trustees' Plan assumes, *contrary to fact,* that the common stock in the reorganized company is inferior in investment quality to the present 7% preferred stock. The courts below, without any analysis whatever, have simply made the same erroneous assumption as the basis for

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[4] If, of course, the vast majority of the stockholders in the new company should rush to convert their shares into cash then the whole "Plan of Reorganization" will have become a farce, without any business purpose and designed merely to evade Federal taxes on liquidation.

imposing on the junior securities the additional burden of paying a bonus to the 7% stockholders.

As the Debtor is now capitalized, the interest of the 7% preferred stockholders is junior to a debt of about $21,000,000. The remaining assets of the Debtor, other than contingent claims and after reorganization expenses, are barely sufficient to cover the liquidating preference of the 7% preferred stock with arrears of dividends to date. It is obvious that such a stock is "preferred" only in a legal, not an economic sense. From an investment point of view, it has all the drawbacks of a common stock junior to a large debt. The full effect of any shrinkage in the value of the Debtor's assets must be borne by that class. The benefit of any substantial appreciation in assets will, however, not go to them but initially to the 6% preferred stockholders and ultimately to the holders of the common stock. Accordingly, the 7% preferred stock has the disadvantages without the advantages of a common stock.

The Trustees' Plan of Reorganization radically alters the position of the 7% preferred stockholders by eliminating the entire debt and at the same time wiping out the rights of the 6% preferred and common stockholders to share in any appreciation. The 7% preferred stockholders will rank equally with the debenture holders as owners of the new debt-free corporation with the privilege of redeeming their stock at asset value.

From these undisputed facts the conclusion is inescapable that the 7% stockholders are suffering no "loss of position"—that on the contrary, their position is improved immeasurably. Consequently, the bonus or premium which the Plan awards them at the expense of the junior stockholders, is utterly unjustifiable.

The injustice of the bonus provision is emphasized by the fact that the 7% preferred stockholders bitterly fought

both the amended Debtor's plan and the amended Kelly plan under which the junior stockholders would put new money into the enterprise which would reduce the corporate debt, so improving the position of the 7% preferred stock. The Kelly Plan provided that the rights of the 7% preferred stockholders would be undisturbed so that they would participate in the benefits resulting from the reduction of debt and interest charges without surrendering any economic equivalent.

Like the debenture holders, the 7% preferred stockholders will benefit, not suffer, from the opportunity to continue their investment in the new corporation without payment of taxes. Like the debenture holders, they would also penalize the junior stockholders for what is in fact a benefit.

The rigid arbitrary approach taken in the instant case, in lieu of the requisite comparison to determine whether the new securities are the equitable equivalent of the old, is a shocking negation of the "informed judgment of the Commission and the District Court on consideration of all the relevant facts" which this Court has prescribed. *Group of Investors of Chicago, etc., R. R., supra,* at 565-566.

A reiteration and demonstration of the proper test is required to dispel the notions that an estate able to do so can be prevented from paying off its creditors in cash and that a good common stock cannot be the economic equivalent of a bad preferred stock or a bad bond. These issues will arise again and again not only in Chapter X reorganizations, but in those governed by Sec. 77 of the Bankruptcy Act (11 U. S. C. A. Chap. 8, Sec. 205) and Sec. 11 of the Public Utility Holding Co. Act of 1935 (15 U. S. C. A. Sec. 79k).

III. MAY THE COMMON STOCKHOLDERS OF A SOLVENT CORPORATION, WHOSE RIGHTS ARE ALTERED BY A PLAN OF REORGANIZATION, BE DENIED THE RIGHT TO VOTE ON SUCH PLAN, ESPECIALLY WHERE THE COMMON STOCKHOLDERS ARE ACCORDED A PARTICIPATION THEREUNDER?

Section 174 of the Bankruptcy Act, the material portion of which is quoted above, makes plain that the Reorganization Court must submit an approved plan to each class of stockholders "affected" thereby.

The order below rejected presentation of the Trustees' Plan to the common stockholders on the ground that they "are not affected by the Plan inasmuch as the value of the assets of the Debtor, other than contingent assets, is less than the amount of claims of creditors and interests of preferred stockholders of the Debtor". (R. 256, par. VIII) We believe that this is on its face erroneous and a flagrant abridgement of rights expressly conferred by Chapter X. This violation of the plain terms of the statute calls for the exercise of the corrective powers of this Court.

Section 107 of Chapter X (11 U. S. C., Sec. 507) defines the term "affected" in the provision that "stockholders . . . shall be deemed to be 'affected' by a plan only if they . . . shall be materially and adversely affected thereby." It is well settled that the term "affected" is to be given its natural meaning. (Cf. *Re National Lock Co.*, 9 F. Supp. 432). To say that the common stockholders are not affected by the Trustees' Plan, which cuts off their rights in the reorganized company, is like saying that the prisoner on the block is not affected by the guillotine.

It is true, of course, that stockholders of an insolvent corporation may not vote. This, however, is not because they are "not affected", but by specific provision (Chapter X, Sec. 179). Here the Debtor is clearly solvent. Furthermore, there is no finding that the common stock is worthless. On the contrary, provision has been made for them in the

Trustees' Plan and their surviving rights are carefully defined therein. That these rights are limited to the contingent assets is clearly irrelevant to the question of whether or not they are affected.

In determining whether a class of security holders is affected by a plan, the pertinent question is whether by the terms of the plan, its "rights are . . . altered". *Kyser* v. *MacAdam*, 117 F. (2d) 232 (C. A. 2). In that case, creditors were held affected by a plan because of "the extensive change made in the amount and status of their claims". Here there can be no question of the extensive changes the Plan makes in the rights of the common stockholders. There is a segregation between the assets of the reorganized company and contingent assets; the common stockholders are denied any participation at all in the former, the Plan confining their further interest to the latter. Even the interest which the Plan allows to remain in the common stockholders, is affected. For example, the Plan provides that the preferred stockholders shall get interest at seven percent on unpaid par and arrears in full before the common stockholders are allowed to participate in the contingent assets. This provision, quite apart from the fact that it is inequitable and contrary to bankruptcy law,[5] manifestly affects the common stock.

The fact that it has been assumed that the common stockholders would vote against the Plan, is obviously no excuse for ignoring the unequivocal requirement of the statute that they be allowed to vote.

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[5] Cf. *Vanston Bondholders' Protective Committee* v. *Green*, 329 U. S. 156.

IV. MAY A PLAN BE APPROVED WITHOUT GIVING TO THE COMMON STOCKHOLDERS THE NOTICE OF HEARING WHICH IS REQUIRED BY THE PLAIN TERMS OF SECTION 171 OF THE BANKRUPTCY ACT?

Section 171 (U.S.C.A., Sec. 571) provides that notice of hearings must be given to the stockholders. No exceptions are made to this requirement. Since no reasonable notice was given to the common stockholders with respect to the actual hearings on approval of the various plans filed, the order of approval is invalid. The only notice we are aware of in this connection, was sent to preferred stockholders more than a year before, of a hearing then to be held. The hearing was not held as scheduled, but instead was adjourned from time to time. The adjournments totalled a year or more until hearings were finally held. No notification was sent to the common stockholders informing them of these hearings. This would not appear to be adequate notice under the circumstances. It should also be pointed out that in fact the great majority of the common stockholders were not represented at the hearing and they had no effective opportunity to be heard.

This serious violation of the procedural safeguards of the Bankruptcy Act also calls for the exercise of the corrective powers of this Court.

Conclusion

The cumulative effect of the errors below is a destruction of the interests of the owners of a prosperous company, without parallel in reorganization history. It defies ingenuity to devise a plan or a procedure which could more effectively denude some classes to give large windfalls to others. The timing of the Plan, which the Trustees seek to push through while the plenary suit is yet on trial, makes its effect doubly inequitable, particularly since their Plan seriously undervalues important assets of the estate. (R.

311-318). It is difficult to understand how any court could have sanctioned so flagrant a disregard of the fundamental principle that "A court of reorganization guards with equal solicitude the equity of stockholders and the priority of creditors." (*In re Equitable Office Building Corp.*, unreported opinion of Mr. Justice Reed, granting a stay on application of stockholders, p. 5, August 6, 1946.)

For the reasons stated, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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